CLIENTALERT

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The "Stay Rules" – what this means for authorized institutions and their affiliated companies in Hong Kong

What are the Stay Rules?

On 27 August 2021, the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights — Banking Sector) Rules (Cap. 628C, Laws of Hong Kong, the "**Stay Rules**") came into force, requiring "**covered entities**" to include provisions in certain non-HK law governed "**financial contracts"** to the effect that the contractual parties agree to be bound by any suspension of termination rights that may be imposed by the Hong Kong Monetary Authority (the "**HKMA**").

The Stay Rules were made pursuant to section 92 of the Financial Institutions (Resolution) Ordinance (Cap. 628, Laws of Hong Kong, the "**Ordinance**"), which allows the HKMA to implement rules to ensure the effective implementation of the suspension of termination rights regime that already exists under section 90 of the Ordinance.

The purpose of the Stay Rules is to ensure effective cross-border suspension of termination rights imposed under the laws of HK with respect to contracts governed by non-HK laws. The HKMA's view is that counterparties to a covered contract should not terminate or close out their positions solely as a result of the covered entity's entry into resolution. The introduction of the Stay Rules therefore reduces the risk of disorderly termination of non-HK law contracts on a mass scale.

Seen another way, the Stay Rules can be said to be HK's version of Article 55 of the European Union's Bank Recovery and Resolution Directive.

Key definitions under the Stay Rules

A brief summary of the key definitions under the Stay Rules are set out below.

(a) A "covered entity" means (i) an authorised institution incorporated in HK (an "**AI**"), (ii) a Hong Kong holding company of an AI, or (iii) a related company of an AI.

(b) A "covered contract" means a financial contract that is governed by non-HK law and contains a termination right exercisable by a counterparty (other than an excluded counterparty).

(c) An "excluded counterparty" means the HKMA and any financial market infrastructure, government or central bank.

(d) A "financial contract" means:

   (i) a securities contract that is:

      (1) a contract for the purchase, sale or loan of a transferable security (or a group or index thereof);

      (2) a repurchase or reverse purchase transaction on a transferable security (or a group or index thereof); or

      (3) a securities margin financing transaction

   (ii) a commodities contract that is:

      (1) a contract for the purchase, sale or loan of a commodity (or a group or index thereof); or

(2) a repurchase or reverse purchase transaction on a commodity (or a group or index thereof);

(iii) a derivative contract;

(iv) a contract for the purchase, sale or delivery of HK currency or any other currency;

(v) a contract of a similar nature to item (i), (ii), (iii) or (iv) above; or

(vi) a master or other agreement insofar as it relates to a contract listed in any of items (i) to (v) above,

but excludes contracts for short-term inter-bank borrowing with an original maturity of 3 months or less.

What do covered entities need to do?

Covered entities must ensure that covered contracts contain a term or condition (made, or evidenced, in writing) to the effect that the parties agree in a legally enforceable manner that, despite any other term or condition of the contract or any other agreement, arrangement or understanding, the parties (other than an excluded counterparty) will be bound by any suspension of termination rights in relation to such contract that may be imposed by the HKMA (a "**suspension of termination rights provision**").

The Stay Rules also require covered entities to have adequate systems of control and record-keeping in place to ensure and demonstrate compliance with the Stay Rules. Covered entities must notify the HKMA of any failures of compliance.

Where a covered entity fails to include a suspension of termination rights provision in any of its covered contracts, the HKMA may require such covered entity to implement a rectification plan for such failure. The HKMA will also be empowered to require a covered entity to provide a legal opinion on the enforceability of a suspension of termination rights provision.

Does this have any impact on conventional loan agreements?

Our informal discussions with the HKMA and other market participants, as well as the HKMA's Consultation Conclusion on the Stay Rules issued on 31 December 2020, all strongly suggest that standard form APLMA-style loan agreements loans denominated in HKD and/or other currencies governed by English (or other non-HK) law ("**conventional non-HK law loan agreements**") are not "contract[s] for the purchase, sale or delivery of HK currency or any other currency", and more importantly, not a "financial contract". This is despite the fact that, as a matter of HK law, a loan involves (i) the delivery by the lender to the borrower of the currency of the loan on drawdown, and (ii) the delivery by the borrower to the lender of the same currency when making principal, interest and other payments. Instead, item (iv) of the definition of "financial contract" is only intended to cover currency contracts such as foreign exchange contracts.

Therefore, unlike the UK's "bail-in rules", which covers conventional loan agreements, there will not be any need for covered entities to include a HK-law version of the LMA's standard form bail-in clause into their conventional non-HK law loan agreements.

Similarly, typical hedging arrangements used in conventional non-HK law loan agreements which are secured would not be "a contract for the purchase, sale or delivery of HK currency or any other currency", but may or may not (depending on the facts) fall within the other heads of what constitutes a "financial contract".

Conclusion

Despite the Stay Rules not applying to conventional non-HK law loan agreements, the Stay Rules have a material impact on the other businesses of covered entities (e.g. structured products). In this respect, covered entities should revisit their operational systems to ensure that they are capable of complying with the Stay Rules, and also to ensure that its documentation for covered contracts include a suitable suspension of termination rights provision.

Please get in touch if you are interested in discussing any of the above.

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